

No. 76-388

Supreme Court, U. S.

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In the Supreme Court of the United States

OCTOBER TERM, 1976

**BERNARD E. NIEDERMAYER AND TESSIE S. NIEDERMAYER,
PETITIONERS**

v.

COMMISSIONER OF INTERNAL REVENUE

**ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR
THE NINTH CIRCUIT**

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. A-5 to A-26) are reported at 62 T.C. 280. The opinion of the court of appeals (Pet. App. A-1 to A-2) is reported at 535 F. 2d 500.

JURISDICTION

The judgment of the court of appeals was entered on April 30, 1976 (Pet. 2), and a petition for rehearing *en banc* was denied on June 23, 1976 (Pet. App. A-3 to A-4). The petition for a writ of certiorari was filed on September 15, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the proceeds of the sale by petitioners of the common stock of a corporation controlled by them and two of their sons to a second corporation controlled by their three other sons were taxable as a dividend under Section 304 of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 301, 302, 304 and 318 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in the Appendix, *infra*, pp. 1a-5a.

STATEMENT

Petitioners, who are husband and wife, owned 22.58 percent of the common stock and 125 shares of the \$100 par value, 6 percent cumulative preferred stock of American Timber & Trading Co., Inc. ("Timber"). Two of their sons, Bernard E. Niedermeyer, Jr., and Walter E. Niedermeyer, owned 67.91 percent of Timber's common stock. Three other sons, E. C. Niedermeyer, L. J. Niedermeyer, and T. J. Niedermeyer, owned 67 percent of the common stock of Lents Industries, Inc. (Pet. App. A-6 to A-9).

On September 8, 1966, petitioners sold all of their Timber common stock to Lents for \$174,975.12, at a time when Lents' earnings and profits exceeded that amount. Petitioners retained their Timber preferred stock until December 28, 1966, when they contributed it to the Niedermeyer Foundation, and claimed a \$12,500 charitable deduction on their 1966 federal income tax return. On September 24, 1968, petitioners filed an amended federal income tax return for 1966, to which they attached an agreement, pursuant to Section 302(c)(2)(A) (iii) of the Internal Revenue Code of 1954, to notify the Commissioner of any acquisition by them of Timber

stock (other than by inheritance) or of their acceptance of an officership, directorship, or other employment in Timber (Pet. App. A-9 to A-10).

Petitioners reported the gain from the sale of their Timber stock as long-term capital gain. On audit, the Commissioner determined that the proceeds of sale of the Timber stock were taxable as a dividend at ordinary income rates on the ground that after application of the family stock ownership attribution rules of Section 318 of the Code, petitioners were in "control" of Timber and Lents within the meaning of Section 304(c). The Commissioner thereby concluded that the transaction was a "brother-sister" corporate stock redemption under Section 304(a)(1) to which none of the exceptions of Section 302(b) were applicable (Pet. App. A-12 to A-13).

The Tax Court upheld the Commissioner's determination (Pet. App. A-12 to A-26) and the court of appeals affirmed *per curiam* (Pet. App. A-1 to A-2).

ARGUMENT

1. The decision below correctly held that the proceeds of petitioners' sale of their Timber common stock to Lents Industries, Inc. was taxable to them as a dividend. Section 304(a)(1) of the Code, Appendix, *infra*, p. 3a, generally provides that if one or more persons are in "control" (50 percent or more stock ownership) of each of two corporations (here Timber and Lents) and if one of those corporations acquires stock in the other corporation from the person or persons in control, then the transaction shall be treated as a distribution in redemption of the stock of the acquiring corporation (Lents) under Section 302. Pursuant to Section 304(b)(1), the determination under Section 302 shall be made with respect to the stock of the issuing corporation (Timber).

The legislative intent underlying Section 304(a)(1) was to discourage the use of related, commonly controlled

corporations to bail out corporate earnings at capital gains rates, and to "characterize as redemptions distributions which are cast in the form of sales." S. Rep. No. 1622, 83d Cong., 2d Sess. 239 (1954). See generally Kahn, *Basic Corporate Taxation* 50-53 (1973 ed.). Thus, "in any case in which 1 or more persons who are in control of each of 2 corporations (brother-sister corporations) sell the stock of one of the corporations to another of such corporations the proceeds of such sale shall be considered to be an amount distributed in redemption of the stock of the corporation which purchased the stock" (S. Rep. No. 1622, *supra*, at 239), and the determination whether such sale "is, by virtue of section 302(b), to be treated as a distribution in part or full payment in exchange for such stock * * * shall be made by reference to the stock of the corporation issuing the stock purchased." (S. Rep. No. 1622, *supra*, at 240.) By applying the attribution rules of Section 318 in determining whether common control of such corporations exists, Congress intended that "an individual shall be considered as owning stock owned directly or indirectly by or for his children." H. R. Rep. No. 1337, 83d Cong., 2d Sess. A96 (1954).

Prior to the transaction at issue, petitioners owned 22.58 percent of the common stock of Timber. Two of their sons owned 67.91 percent of the Timber common stock. Thus, for purposes of the family stock attribution rules of Section 318(a)(1),¹ petitioners owned 90.49 percent of the Timber common stock. Three of petitioners' other sons owned 67 percent of the stock of Lents, the ownership of which was also attributed to petitioners.

¹The family and corporate stock attribution rules of Section 318(a)(1)(A)(ii) and 318(a)(2)(C) are made specifically applicable to this transaction by Section 304(c)(2).

Pursuant to Section 304(c)(1), petitioners were therefore in "control" of both Timber and Lents prior to their sale of their Timber stock to Lents. Moreover, under Section 304(a)(1), their sale is regarded as a redemption of the stock of Lents to be measured under Section 302 by their ownership of Timber stock before and after the transaction.

It is undisputed that under the attribution rules, petitioners are deemed to have held 90.49 percent of the Timber common stock before the sale and 82.96 percent after the sale to Lents. Accordingly, petitioners no longer argue that the sale was a "substantially disproportionate redemption of stock" under Section 302(b)(2). Nor did petitioners' sale qualify as a complete "termination of shareholder's interest" under Section 302(b)(3). That provision only applies if "the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder." Since petitioners retained 125 shares of Timber preferred stock until December 28, 1966, the sale was not a complete termination of interest under Section 302(b)(3).²

2. Petitioners contend (Pet. 8-10) that the transaction qualifies for capital gains treatment as a "redemption * * * not essentially equivalent to a dividend" under Section 302(b)(1). They complain (Pet. 9) that the application of the attribution rules is unfair because they did not in fact control either Lents or Timber but were only deemed to control these corporations through their sons' stock ownership. But in *United States v. Davis*,

²Although petitioners contend (Pet. 10) that application of the attribution rules in this case imposes hardship on family-owned businesses, they acknowledge (Pet. 14) that they would have achieved capital gains treatment under Section 302(b)(3) had they not retained the 125 shares of Timber preferred stock.

397 U.S. 301, this Court held that the stock attribution rules of Section 318(a) apply to all of Section 302, observing that such a result was "in accord with the decisions of the other courts of appeals, a longstanding treasury regulation, and the opinion of the leading commentators" (397 U.S. at 306; footnotes omitted).

In *Davis*, the Court held that regardless of business purpose, a redemption is always "essentially equivalent to a dividend" within the meaning of Section 302(b)(1) if it does not change the shareholders' proportionate interest in the corporation. Since the transaction at issue resulted in a reduction in petitioners' interest in Timber common stock only from 90.49 percent to 82.96 percent, the Tax Court correctly concluded that their "control and ownership of [Timber] is essentially unaltered and cannot be considered to have undergone a meaningful reduction" (Pet. App. A-18).

Petitioners nevertheless contend (Pet. 8-10) that this Court should reconsider the rule announced in *United States v. Davis, supra*. They subscribe to the arguments advanced in the dissenting opinion filed on behalf of three members of the Court (Powell, Douglas, and Blackmun, JJ.) from the denial of certiorari in *Miele v. Commissioner*, 474 F. 2d 1338 (C.A. 3), certiorari denied *sub nom. Albers v. Commissioner*, 414 U.S. 982. But quite apart from the merits of the *Davis* rule, the considerations expressed by the dissenting opinions there (397 U.S. at 313-314) and in *Albers* do not support petitioners' claims.

In those cases, the taxpayers urged that the issuance of the redeemed stock and the stock redemptions were prompted by independent non-tax business reasons that arguably justified capital treatment. In both of those cases, the taxpayers subscribed to a particular stock issue to fund a specific corporate activity and redeemed their stock when the business need came to an end. Here, how-

ever, there is nothing in the record to suggest that petitioners' purchase of Timber common stock and subsequent sale of it to Lents were supported by non-tax business motives.³ Thus, while we submit that *Davis* was correctly decided, this case does not present the question resolved in that case as to whether Section 302(b)(1) requires "a factual determination as to the business purpose of the stock redemption" (*Albers v. Commissioner, supra*, 414 U.S. at 986 (dissenting opinion)).⁴

3. Finally, petitioners contend (Pet. 15-17) that the decision below conflicts with *Robin Haft Trust v. Commissioner*, 510 F. 2d 43 (C.A. 1). There, the court remanded the case for further findings on whether there was sufficient enmity between the taxpayers and the persons whose stock was being attributed to them so as to foreclose the application of the stock attribution rules. But there is nothing in the record here to support the existence of any hostility between petitioners and their son Bernard, whose stock was attributed to them (Pet. App. A-2, A-14 to A-15). There is accordingly no basis in this case for any "family hostility" exception to the application of the stock attribution rules. Cf. *Squier v. Commissioner*, 35 T.C. 950.

³Petitioners assert (Pet. 9) that "[t]here was a good business reason for Lents acquiring the [Timber] stock." However, they do not further elaborate upon this point.

⁴Petitioners also contend (Pet. 10-15) that the decision below erroneously extends the *Davis* rule because they did not actually own the stock and because there was no tax avoidance motive for the transaction. But the taxpayer in *Davis* made the same claims (see 397 U.S. at 305, 311-312).

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1976.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * * * *

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

* * * * *

(3) *Termination of shareholder's interest.*—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

* * * * *

(c) *Constructive Ownership of Stock.*—

(1) *In general.*—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

(2) *For determining termination of interest.*—

(A) in the case of a distribution described in subsection (b)(3), section 318 (a)(1) shall not apply if—

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

* * * * *

(d) *Redemption Treated as Distributions of Property.*—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

* * * * *

SEC. 304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS.

(a) *Treatment of Certain Stock Purchases.*—

(1) *Acquisition by related corporation (other than subsidiary).*—For purposes of sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

* * * * *

(b) [as amended by Sec. 4(b)(1), Act of August 31, 1964, Pub. L. 88-554, 78 Stat. 761] *Special Rules for Application of Subsection (a).*—

(1) *Rule for determinations under section 302(b).*

—In the case of any acquisition of stock to which subsection (a) of this section applies, determinations as to whether the acquisition is, by reason of section 302(b), to be treated as a distribution in part or full payment in exchange for the stock shall be made by reference to the stock of the issuing corporation. In applying section 318(a)

(relating to constructive ownership of stock) with respect to section 302(b) for purposes of this paragraph, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

* * * * *

(c) [as amended by Sec. 4(b)(1), Act of August 31, 1964, *supra*] *Control*.—

(1) *In General*.—For purposes of this section, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) shall be treated as in control of such other corporation.

(2) *Constructive ownership*.—Section 318(a) (relating to the constructive ownership of stock) shall apply for purposes of determining control under paragraph (1). For purposes of the preceding sentence, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) *General Rule*.—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) *Members of family*.—

(A) *In general*.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

* * * * *

(ii) his children, grandchildren, and parents.

* * * * *

(2) [as amended by Sec. 4(a), Act of August 31, 1964, *supra*] *Attribution from partnerships, estates, trusts, and corporations*.—

* * * * *

(C) *From corporations*.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.